Private Company Accounting Drivers in Asia

Satinder Bhatia

Abstract— **Private company accounting is gaining momentum in all parts of the globe. Ever since the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) for Small & Medium Enterprises (SMEs) or private / unlisted companies, there has been a growing acceptance around the world for mandatory accounting disclosures by the private sector. Some Asian countries have made much headway and have already issued standards mandatory for private companies. Others will have to follow soon as part of good corporate governance practices to keep alive the interest of foreign investors in mergers, acquisitions and other projects.**

***Index Terms*—Corporate Governance, Deal Valuation, Financial Credibility, Private Company Reporting**

I. Introduction

Accounting is currently undergoing a massive transformation across all continents. Organizations which have traditionally not been covered by any regulation are also beginning to feel regulations come close to their heels. The International Accounting Standards Board (IASB) based in UK came out with International Financial Reporting Standards (IFRS) for Small and Medium Enterprises (SMEs) in July 2009 which are already applicable not only in some European countries but Australia and South Africa as well. Accounting regulators are currently focusing attention on unregistered, private companies which account for most of the global economic activity and which far outnumber the publicly registered companies. US, for example, has approximately 30 million Small & Medium Enterprises (SMEs) as against 20,551 public companies [1]. The Federal Accounting Standards Board (FASB) of USA has also come out with draft Private Company Financial Reporting Standards inviting comments from professional bodies [2]. Since the IFRS has not yet been adopted in the USA, there have been certain sensitivities in applying the IFRS for SMEs to the small and medium businesses there.

But clearly, the intention is quite evident – that all enterprises have to abide by certain common prudent measures to commit to financial integrity. Canada has also come out with private company reporting standards although option was available to such companies to adopt full IFRS [3].

II. Early Drivers for Accounting Changes

The Sarbanes-Oxley (SOX) Act enacted in 2002 was the first big measure in this direction in USA covering publicly listed companies [4]. Over time, though, its impact percolated to the private companies as well. The Act had instituted mandatory accountability practices for financial institutions and public limited companies which have become almost 'best practices' for the entire corporate sector and lenders and other stakeholders expect private companies to be also SOX-compliant. The publicly traded companies, under the Act, had to disclose the internal controls that they have in place so that chances of fraud are minimized. Understandably, this instilled some sense of confidence amongst investors and lenders alike. And since most businesses are small and medium businesses, investors are demanding disclosure of internal control systems of these companies as well. The private companies most affected by SOX are those contemplating an Initial Public Offering (as they have to be SOX compliant at the time of filing); those preparing for a merger with public companies (potential public buyers take into consideration SOX compliance as a measure of the suitability of the target company); those issuing publicly registered debt (underwriters insist on SOX compliance); those reporting to Federal Regulatory agencies; those relying on lenders or insurers for capital access or business insurance renewal and those doing business with government entities including state governments. Thus, appointing independent directors on the boards of even private companies has become a norm and is considered as an industry standard. Similarly, no external auditor can take up non-audit work in the same company, public or private and all non-audit work has to be approved by an audit committee consisting of independent directors, at least one of whom is a financial expert. Besides, the CEO, controller, CFO, chief accounting officer, or any person in an equivalent position cannot have been employed by the auditing firm during the 12 months preceding the audit. The difficult section in SOX is section 404 which requires companies to report on the effectiveness of internal controls over financial reporting at the end of each fiscal year

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and the report is to be duly whetted by an external auditor.

III. Mergers & Acquisitions – Driving Accounting Changes in Asia

Pressure on private companies to be SOX-compliant has also come from the large number of mergers and acquisitions that take place in the US. Bloomberg data on global mergers & acquisitions reveal that US is a lead buyer as well as a target in merger deals [5]. The data by Dealogic firm on M&As, too, show that no other country came close to USA in 2011 in terms of the value of merger deals.

Fig. 1. Cross-Border Deals by Location of Acquirers

Japanese companies, too, made aggressive moves abroad in 2011 as the yen surged. Propelled by a strong yen and corporate enthusiasm for growth outside the saturated home market, Japan leapfrogged rivals like China to become the third-biggest cross-border acquirer behind the U.S. and the U.K. in 2011 by value of deals [6]. The value of mergers and acquisitions abroad by Japanese companies in 2011 totalled a record $79.7 billion, led by Takeda Pharmaceutical's $14 billion purchase of closely held Swiss competitor Nycomed. That put Japan, which ranked 10th in cross-border purchases in 2010, just behind the U.K., with $83.95 billion of such deals, though still well behind the U.S. with $186.6 billion. China held on to the fifth slot in 2011 with about $49.5 billion in deals. In terms of acquisition targets, within Asia-Pacific region, by NDTV sources (2011), China was the most targeted nation in the region with USD 188.2 billion worth of deals, followed by Australia with USD 136.4 billion and South Korea with USD 53.6 billion [7]. The increased interest has arisen as most firms see mergers and acquisitions as a way to build scale, access new markets and brands as well as technology.

As per the Grant Thornton International Report - GRI of 2011, nearly half (44%) of privately held businesses in the BRIC economies were planning to grow by acquisition in 2011 as against the global average of 34% [8]. India also showed a big increase from 22% of firms planning to grow through acquisition in 2010 to 41% in 2011. The following graph is an extract from the GRI Report:

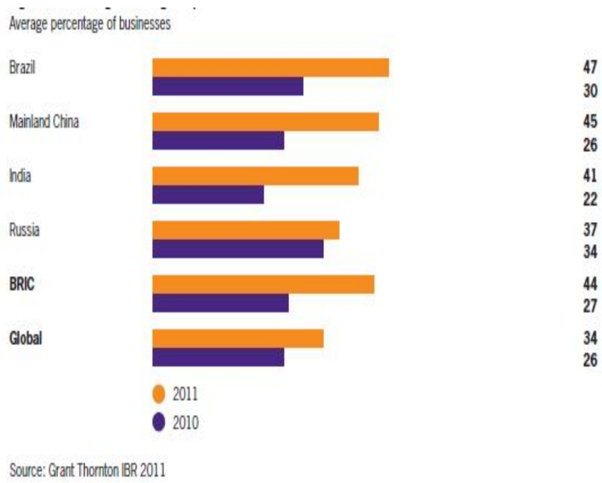

Fig. 2. Acquisition Plans of Different Countries – 2010-2011

Some of the noteworthy private deals in India in 2011 had been Abbott Laboratories-Piramal Healthcare; Atlas-Reliance; Bharti Airtel-Zain Africa; Enam-Axis Bank; GCPL-P T Megasari Makmur Group; JSW Steel-ISPAT Ltd and Kalanithi-SpiceJet. Among the most important developments in Asia's and India's M&A activity has been the rapid rise in outbound deals in a bid to enter new markets, with opportunities for increased distribution, market share, customer ties, and positioning as a low-cost alternative. These deals can also enable a company to buy a brand with strong cachet that can't be replicated, as China-based Zhejiang Geely achieved with its purchase of Volvo [9]. Singapore-based Olam International has used acquisitions to grow itself into a leading global supply chain manager for food ingredients and agricultural products. In 2006, the company was not making any M&A deals, but only four years later its acquired companies were generating around 30 percent of its earnings. As per the report by Bloomberg, from 2007 to 2010, Olam International completed no fewer than 17 deals, investing a total of $1.4 billion and achieving a 25 percent return on equity and a 14 percent return on invested capital from those acquisitions. The company has used M&A to build leadership positions in its existing businesses, expand into adjacent businesses, overcome entry barriers in new markets, acquire new capabilities, and take advantage of favorably priced targets with high business overlap. Moreover, it has clear guidelines for deal frequency, size, timing, and level of ownership. For example, Olam favored the "string of pearls" approach in the last decade: Instead of a few headline-making deals, it focused on a series of small deals over a multiyear period, establishing a maximum deal size of 10 percent of its market cap and a maximum annual deal volume of 15 percent of its market cap. Obviously, then, the focus was on acquisition of private companies.

Similarly, Indian household and personal care products maker Godrej used a well-honed acquisition strategy to grow its domestic leadership and international reach. Recognizing that M&A was critical to achieving its global goals, the company spent two years of disciplined preparation before setting foot in the M&A market. It assembled a strong M&A team and developed a playbook including a detailed integration manual and a rigorous screening process to identify the right acquisition candidates. Since January 2010, Godrej has done eight deals worth about $750 million in total. Godrej focuses on three categories (hair care, home care, and personal wash) and targets companies with leading positions. Recent acquisitions are market leaders:

Megasari is Indonesia's second-largest household insecticides player, Issue Group and Argencos are the hair color leaders in several Latin American markets, and Darling Group is the leader in hair extensions across 14 countries in sub-Saharan Africa. This carefully executed M&A strategy in 2010 enabled the company's global business accounting for more than 30 percent of revenue—largely fueled by its international acquisitions—and contributed $14 million in net earnings.

Surely, attention to financial governance and due diligence including accounting information becomes crucial to achieving sustainable benefits of such deals.

IV. Research on Economic Impact of Accounting Quality

The results of research by Waroonkun, Satha Ussahawanitchakit, Phapruk (2011) indicate that the greater degree of accounting quality is more likely to achieve higher firm survival through accounting outcome [10]. The authors also demonstrated that firms with higher degree of information transparency and information valuables promote greater accounting performance and higher corporate stability and firm survival. Earlier, Bushman and Smith (2001) concluded that a good financial reporting system lowers the cost of capital and improves capital allocation efficiency [11]. Maureen F. McNichols and Stephen R. Stubben (2009) found that acquiring firms in acquisitions experience lower stock returns at the acquisition announcement when the value of the target firm is more uncertain [12]. However, they also found that, controlling for uncertainty, acquirer returns are higher when the target firm has higher accounting information quality. The positive effect of accounting information quality offset the negative effect of uncertainty for target firms with high accounting information quality. Carol Marquardt and Emanuel Zur (2010) found that high quality accounting information also reduced costs of negotiation, as it helped in identifying the bidder that valued the target firm most highly [13]. Hilary (2006) and Biddle, Hilary and Verdi (2009) related accounting quality to capital investment efficiency [14, 15]; and Francis and Martin (2010) found that firms with more conservative accounting practices made more profitable acquisitions [16]. Overall, these findings suggested that firms with high quality accounting information made better investment decisions.

Another study by Bushman and Smith (2011) concluded that high-quality financial reporting by firms is important for both internal and external evaluation of business performance [17]. For internal decision-making, high-quality financial information helps business managers identify good projects and increase investment efficiency. For external purposes, disclosure of financial information allows providers of capital to better assess the firm's investment opportunities and monitor managerial actions. In other words, high-quality financial reporting should ease external financing constraints by reducing the adverse selection or moral hazard costs associated with information asymmetry.

Earlier, in a study on Financial Reporting Quality and Economic Growth (2009), authors Feng Li and Nemit O. Shroff investigated the implications of financial reporting quality for a country's economic growth [18]. Their hypothesis was based on the premise that information uncertainty exacerbates the problems of moral hazard and adverse selection, and financial reporting helps mitigate these problems. The authors found evidence consistent with their hypothesis; specifically, industries characterized with information uncertainty grew between 0.12% and 0.22% faster in countries with good financial reporting quality.

Harmonization of information put out by private companies is also important to be able to identify good projects. Hope, Thomas and Vyas (2009) found that while all public firms throughout the world are generally required to have their financial statements audited, this is not true for private firms [19]. In some countries (e.g., Norway and South Africa), nearly all private companies provide audited financial statements, while in other countries (e.g., Brazil), audits of private companies are rare. Across their entire sample, they observe that approximately one-half of private firms choose not to have their financial information reviewed by an auditor.

The new Companies Bill introduced in India in 2011 has incorporated most of the 'best practices' prevalent in other countries [20]. The KPMG poll on corporate governance in India (2009) had noted that majority of the respondents believe that while corporate governance should be practiced through principle-based standards and moderate regulations, there is a need for stronger regulatory review and exemplary enforcement [21]. Earlier, David W. Wright (1996) had found significant correlations between two different measures of financial reporting quality and the composition of firms' boards of directors, particularly the subset of directors serving on the audit committee [22]. The two financial reporting quality measures were (1) analysts' evaluations of corporate disclosure practices and (2) the existence of an SEC Accounting and Auditing Enforcement Release against the firm or its auditors. The most significant findings documented negative correlations between the financial reporting quality measures and the presence of insiders and so-called "grey" directors on the audit committee.

V. PRIVATE COMPANY ACCOUNTING IN ASIA

With many Asian countries switching to international accounting standards, the willingness to change and adopt the best practices in both public and private companies is more than evident. The formation of the Asian-Oceanian Standard-Setters Group (AOSSG) in 2009 to leverage the knowledge on globalising financial reporting standards and share experiences on implementation of the standards amongst each other is expected to serve the region well. Since its formation, the organization's relevance has quickly been acknowledged, in particular, with regard to its comments on proposals issued by the IASB and other bodies of the IFRS Foundation. AOSSG - a grouping of the accounting standard-setters in the Asian-Oceanian region has been formed to discuss issues and share experiences on the adoption of International Financial Reporting Standards (IFRS) and to contribute to the development of a high-quality set of global accounting standards [23]. The AOSSG with 25 members currently (Appendix II) is expected to play an important role in encouraging the adoption of international standards in the region for all business entities. The AOSSG envisions assisting the IASB in undertaking its post-implementation review, field-visits, and effect analysis by utilising the resources and experiences of member jurisdictions and advising its members on significant issues for consideration before and after standards are published. India, along with Japan, Australia, China, Hong Kong, Korea, Malaysia and Singapore as members of the Chairman's Advisory Committee (CAC) of AOSSG is expected to play a substantive role in this process of harmonization of accounting standards for private entities.

Korea's Financial Supervisory Service and the Small and Medium Business Administration (SMBA) have announced that the latter will provide financial assistance to SMEs to help them adopt the IFRS under the 2010 SME consulting assistance project [24]. SMEs that get professional service from accounting firms to adopt the IFRSs are eligible for the financial assistance for consulting cost up to 50 million won (up to 60% of a total project cost). But cost incurred to deploy hardware including IT system is excluded under these rules. SMEs that get professional service from accounting firms to adopt the IFRSs are eligible for the financial assistance for consulting cost up to 50 million won (up to 60% of a total project cost). But cost incurred to deploy hardware including IT system is excluded under these rules. The Hong Kong Institute of Certified Public Accountants (HKICPA), in 2010, issued the Hong Kong Financial Reporting Standards for Private Entities (HKFRS for Private Entities) [25, 26]. These standards are largely similar to the IFRS for SMEs issued by the IASB [27]. Singapore, also in 2010, issued the Singapore Financial Reporting Standards for Small Entities (SFRS for Small Entities) [28]. The SFRS for Small Entities applies as an alternative framework to the Singapore Financial Reporting Standard ("SFRS") for the preparation and presentation of general purpose financial statements of entities for financial reporting periods beginning on or after 1 January 2011. Malaysia, too, has issued the Private Entity Reporting Standards (PERS) [29]. In fact, in Malaysia it is an evolving exercise with the earliest standard for private enterprises issued for aquaculture in 1998. The Philippine Financial Reporting Standard for Small and Medium-sized Entities (PFRS for SMEs) became effective on January1, 2010, with earlier application allowed [30]. The standard was adopted by the Financial Reporting Standards Council (FRSC) from the international version issued by the International Accounting Standards Board (IASB). The Securities and Exchange Commission (SEC) has made the PFRS for SMEs a part of its rules and regulations, requiring covered companies to implement the new standard starting with 2010 financial statements to be filed with the SEC.

Under Indonesian law, both public and private companies must comply with the accounting standards issued by the DSAK-IAI (Dewan Standar Akuntansi Keuangan or the Federal Accounting Standards Board of Indonesia) [31, 32]. In Vietnam, all domestic companies, listed and unlisted, are required to use the Vietnamese Accounting Standards (VASs), which have been developed by the Ministry of Finance [33]. Generally, the VASs are based on IASs that are issued from time to time, though some modifications were made to reflect local accounting regulations and environment.

Over the next few years, it is expected that other Asian countries will have a well documented set of standards for private companies/businesses.

VI. CONCLUDING OBSERVATIONS

Private company accounting in Asia is certainly getting a fillip both from governments of individual countries as well as organizations like AOSSG. The nature and quantum of the impact of these standards will be the interesting research areas in the coming years.

Appendix A: Asian-Oceanian Standard-Setters Group (AOSSG)

Standard Setters from the following jurisdictions currently members of the AOSSG:

- Australia: Australian Accounting Standards Board
- Brunei
- Cambodia: Ministry of Economy and Finance of Cambodia
- China: China Accounting Standards Committee
- Dubai: Dubai Financial Services Authority
- Hong Kong: Hong Kong Institute of Certified Public Accountants
- India: Institute of Chartered Accountants of India
- Indonesia: The Indonesian Institute of Accountants
- Iraq
- Japan: Accounting Standards Board of Japan
- Kazakhstan: Chamber of Auditors of the Republic of Kazakhstan
- Korea: Korea Accounting Standards Board
- Macao: Financial Services Bureau
- Malaysia: Malaysian Accounting Standards Board
- Mongolia
- Nepal: Accounting Standards Board
- New Zealand: New Zealand Accounting Standards Board
- Pakistan: Institute of Chartered Accountants of Pakistan
- Philippines
- Saudi Arabia: Saudi Organization for Certified Public Accountants
- Singapore: Singapore Accounting Standards Council
- Sri Lanka: The Institute of Chartered Accountants of Sri Lanka
- Thailand: Federation Of Accounting Professions
- Uzbekistan: National Association of Accountants and Auditors of Uzbekistan
- Vietnam

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